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C O N F I D E N T I A L SECTION 01 OF 03 RIGA 000803

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TREASURY FOR BILL LINDQUIST

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TAGS: EFIN ECON ETRD PGOV LG
SUBJECT: LATVIA VOTES FOR PAINFUL FISCAL MEASURES, AWAITS
IMF-EU ASSISTANCE, GOVERNMENT REMAINS STABLE - FOR NOW

REF: A. RIGA 729
¶B. RIGA 724
¶C. RIGA 723

Classified By: Charge d'Affaires a.i. Bruce Rogers, for Reasons 1.4 (b) and (d)

¶1. (C/NF) Summary: To qualify for IMF and EU financial assistance, Latvia has adopted a modified 2009 budget and an Economic Stabilization Plan. The measures include deep cuts to public salaries, state services and ministries' expenses, and substantial economic restructuring. These moves, combined with the earlier changes to the original takeover agreement of Parex Bank, have reportedly met both the IMF's and EU's conditions. The government hopes to finalize assistance packages by December 18, with a potential Nordic bridge loan by December 20 and a December 23 IMF Board vote planned. The latest information is that the EU could provide 3 billion Euros, the Nordic countries 2 billion, and the IMF another 1.8 billion. Despite the unpopularity of the measures among voters, the government is likely stable in the short term because nobody else wants to take on the implementation of these tough measures in the coming months. End summary.

Slamming on the Fiscal Brakes

¶2. (U) In the early morning of December 12, aftera twenty-hour session of the Saeima (Parliament), Latvia passed amendments to its 2009 budget and laws to enact the government's Economic Stabilization Plan. The fiscal changes and economic restructuring measures were introduced to meet requirements set forth by the IMF and EU in order for Latvia to receive urgently needed financial assistance. Given Latvian insistence (refs A and B) that the national currency, the Lat, must retain its current peg to the Euro, the required adjustments to Latvia's fiscal policy are particularly severe.

¶3. (U) The 2009 budget was already trimmed-down when passed in November. The December 12 amendments reduce planned expenditures by another 8%. With the slowing economy projected to shrink revenues (which even after increases to VAT and excises taxes could fall 16% below 2008 revenues), the projected 2009 budget deficit will grow approximately 3% of GDP.

¶4. (U) Key items in the amended budget are a 15% cut in public sector salaries and a 25% cut in other government expenses. Subsidy payments from the government (with the exception of health care programs) will be reduced 25% and local governments will be called to reduce their budgets by 25%. The budget sets a goal to reduce the number of public employees by at least 15% from 2008 figures, over the span of

two years.

¶5. (U) The Latvian economy is projected to shrink by almost 5% of GDP in 2009. To compensate for falling revenues, increases were passed to the VAT and several excise taxes. The general VAT rate will increase on January 1 from 18% to 21%. The reduced VAT rate on selected items will increase from 5% to 10%, and the list of goods and services qualifying for the reduced rate will be cut. Partially offsetting the VAT and excise tax increases, the income tax rate will be reduced from 25% to 23%, and the minimum deductible will be raised from 80 Lats to 90 Lats (from $146 to $164 USD).

Economic Restructuring

¶6. (U) Other enacted legislation included continuation of bank deposit guarantees up to 50,000 Euros, permission for the government to issue loan guarantees for syndicated loans which fall due in 2009, increased supervision and monitoring of the financial sector, and the creation of a legislative framework and procedures for public assistance provided to troubled financial institutions. Measures to increase Latvian competitiveness include creation of an export credit insurance system, the merging of all public utility commissions, improvements and consolidation of the health care and education systems, and simplification of bankruptcy and insolvency procedures. Monetary goals, such as maintaining the Lat in its 1% band peg to the Euro and adoption of the Euro by 2012, were also passed.

Busy Two Weeks

¶7. (C) The measures complete a difficult two-week effort by the government to meet guidelines set by the IMF-EU mission. The process accelerated on December 2 when the government bowed to the IMF's specific condition that it take over the remaining shares in Parex Bank from the bank's two previous owners and remove them from the bank's Board. The government is reportedly pursuing arrangements to take over the remaining 15% stake held by minor shareholders, though terms and details have not been specified by the Finance Ministry. While the IMF had most urgently sought to remove the former majority owners from Parex, full nationalization was recommended by the IMF (ref C) during November talks, and press reports indicate that the EU is also conditioning its possible aid on full government ownership of the bank.

¶8. (C) Discussions between Latvia and the IMF had stalled in the last week of November on both the Parex ownership issue and on the lack of clarity of the government's plans to implement economic restructuring without devaluing of the Lat. A Bank of Latvia contact informed us that the IMF team was not (apart from the Parex ownership issue) dictating specific fiscal or restructuring points to the GOL, but was using a "show us what you got" approach. As late as November 26, Ambassador Larson was told by both the Prime Minister and Transportation Minister that they would not agree to the Fund's suggestions on Parex, and would walk away from IMF money if changing the original take-over deal were a condition. While we do not know all the factors that changed the government's position, the Finance Minister told the Ambassador on December 4 that the Treasury was critically short of money. The urgency of obtaining outside funding is likely to have outweighed the government's commitment to the original Parex arrangement, as well as removing any thoughts of walking away from IMF funding. To date, the government has injected almost 500 million Lats ($910 million USD) into Parex, and the new Parex Board Chairman has said publicly that he will seek roughly another $660 million USD from the government when it receives IMF-EU aid.

Finalizing IMF and EU Deals

¶9. (C/NF) Bank of Latvia Governor Rimsevics has told us that the IMF team had previously offered providing Latvia with 1000% of its quota (amounting to 1.5 billion Euros), but in Stockholm on December 10, had lowered that figure to 450% of quota (675 million Euros). However, on December 16, the head of the Bank of Latvia's external relations department, Juris Kravalis (strictly protect), told us the IMF was "happy and impressed" with the Latvian measures, and that the amount recommended by the IMF negotiating team to the IMF Board would likely be closer to the original quota multiple. While he said that assistance figures will not be set until the IMF Letter of Intent is signed, talks are looking at roughly 1.8 billion Euros coming from the IMF, 3 billion Euros from the EU, 2 billion Euros from the Nordic Countries, and an unspecified amount coming from other neighbors or institutions (of which he noted roughly 300 million Euros from the World Bank and 50 million Euros from Estonia). Kravalis said that the IMF Letter of Intent is scheduled to be completed by December 17 or 18, with a vote by the IMF Board on December 23. Financing could be received, he said, within a few working days after the Board's vote, possibly by the end of the year. He hoped that a bridge loan, potentially from Sweden or jointly by the Nordic countries, could be made by December 20.

Comment

¶10. (C) While there has been much criticism by the public of the austerity measures in the budget amendments, there appears to be a general consensus in financial circles that there is no alternative course, given the need for IMF-EU support. Unpopular as these measures are, it appears that no alternative political grouping wants to pick up the government's mess, and there is no immediate threat to the coalition or PM. President Zatlers has expressed his support for PM Godmanis' handling of the situation, and an attempted no-confidence vote in Finance Minister Slakteris failed. Godmanis also benefits from the common interpretation that the financial crisis stems from his predecessor's

economy-stoking policies, not from his decisions, thus potentially saving him from the voters' wrath.
ROGERS